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Dear Nick

Secondary adjustments to transfer pricing legislation

We refer to the consultation document published in May (*Introduction of secondary adjustments into the UK's domestic transfer pricing legislation*) on whether secondary adjustments should be introduced into the UK's domestic transfer pricing (TP) legislation.

Our view is that these proposals should not be taken forward as to do so would not be consistent with the Government's commitment in the Business Tax Roadmap to make the UK's tax system more efficient and competitive, instead they would introduce increased complexity for little benefit, making the UK less competitive. In our view such unilateral rules would cause an increase in double taxation, and serious cash flow problems even if the double taxation issue is ultimately resolved.

In addition, the result of the referendum on the UK's membership of the EU means it is inadvisable to introduce new complex rules that impact on international trade and investment at this time. In particular, uncertainty about the UK position in relation to the EU Arbitration Convention (90/436) makes any unilateral action in this area hazardous at this time. The country needs stability and measures that demonstrate the UK is a competitive place to do business.

The stated preference for a rule to be designed on the basis of constructive loans, rather than as constructive dividends and equity contributions which a few other countries currently have, is also very concerning. We understand that an approach

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based on constructive dividends would not raise revenues as the UK does not have a dividend withholding tax. However, other countries use secondary adjustments as an anti-avoidance measure to prevent taxpayers from circumventing their withholding tax rules, which makes such measures more logical for these countries than the UK.

We would note that secondary adjustments are not addressed in the OECD Model nor in the EU Arbitration Convention and the conversion of a relief from the economic effects of a transfer pricing adjustment to a unilateral revenue raising measure runs contrary to BEPS Action 14. In addition, the absence of conclusive dispute resolution mechanisms and inconsistent treatment by different states on this requires a flexible rather than a fixed legislative approach, and this is supported by the OECD TP Guidelines.

Rather than the UK taking unilateral action, we would strongly suggest that the concept of secondary adjustments should be taken up through the OECD. Consideration could then be given at a multilateral level to whether changes should be made to Article 9 of the OECD Model to address the issue, to recommend domestic law provisions that would be consistent with this, and how disputes in relation to both primary and secondary adjustments will be resolved. This is the approach taken on several BEPS issues and commends itself as a holistic way to address international tax problems. As ever, the UK could play a leading role in developing this.

We also suggest that the revenues that may be raised by such measures would be trivial, given the low interest rates (recently reduced and which are predicted to stay low) and the low (and falling) rate of corporation tax, and does not justify the inevitable increase in complexity and potential unfairness in the tax system that would arise from these measures.

We hope that the Government will re-think these proposals and decide not to introduce a unilateral secondary adjustment rule. However, we also take this opportunity to comment on some of the proposed design points of a secondary adjustment rule raised in the consultation document.

- As noted, both of the concepts discussed in the OECD TP Guidelines to address this issue – constructive dividends and equity contributions – are concepts which are not known in the UK and would not fit well with its wider tax legislation and, thus a third option is presented – treating the excess profits as a deemed loan from the potentially advantaged company. This would be a different approach to that taken by those few other countries that have rules along these lines
- The consultation document suggests that this would be predominantly a punitive measure. This is contrary to the long standing OECD position that such adjustments are to relieve the economic effect of primary adjustments. Other countries (for example, the US) assume that the adjustments should be reflected through deemed dividends/capital contributions. Given the UK is less likely to tax these events, we understand why it is suggested that the adjustments are treated as loans, but this will generate enormous complexity, potentially into perpetuity and inevitable mismatches between UK and foreign tax treatment. In addition, as a matter of fact (and law) the adjustments represent an absolute and permanent transfer of assets, and are not a loan. That is why the appropriate adjustment is a constructive dividend/capital contribution (or a mixture of the two when the relationships are not direct).

- The generally accepted practice where a primary adjustment is made under competent authority proceedings is to waive any interest due. The consultation document discusses primary adjustments as if they are simply an adjustment to UK profits that is required because the transfer pricing was wrong, rather than because there was a dispute between two countries. Transfer pricing inevitably operates within a range of acceptable outcomes; that there is a primary adjustment does not necessarily indicate that the taxpayer was 'wrong'. A taxpayer with pricing within an acceptable range may accept a primary adjustment as a pragmatic decision in order, for example, to close an enquiry. In such circumstances imposing a penal rate of interest is very unfair and punitive. However, without explicitly carving it out, the implication is that interest would fall due on additional tax following competent authority proceedings (which may take a significant amount of time and be outside the control of the taxpayer). We would therefore suggest that in such cases no interest should be payable on any such primary or secondary adjustments.
- The consultation document states that double tax relief would be available on secondary adjustments where there is a treaty in place. However, if the UK is to introduce secondary adjustment rules it would seem equitable to also allow some form of unilateral relief against other countries' secondary adjustments even where there is no treaty in place.
- The suggested de minimis for primary adjustments of £1 million is much too low. This figure should be considerably higher.
- There is nothing in the consultation document about netting. We assume that this would be allowed but please can you clarify this. We are concerned about cash pool examples where there can be swings one way or the other. It would be even more unfair to end up with fictional loans going both ways between the same entities (or groups of entities in a cash pool) and interest being imposed on adjustments relating to gross amounts.
- We are also concerned about the potential impact on UK/UK transfer pricing which is not carved out of the proposals and so could also give rise to a constructive loan and penal interest. The constructive interest income would presumably be taxed – but would a deduction be allowed for the constructive interest expense?

Yours sincerely

Joy Svasti-Salee
Chair, International Taxes Committee

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